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Earnings management and audit quality: Stakeholders' perceptions

Yasser Barghathi, David Collison, and Louise Crawford

1. Introduction

Perceptions of audit quality have recently been identified as a topical and important issue as a result of audit failures and corporate collapse (Kilgore et al., 2014). Calls for mandatory audit firm rotation and industry specialist auditors on audit quality have been made as a result of high-profile accounting scandals such as Enron and WorldCom (Firth et al., 2012; Kilgore et al., 2014; Anis, 2014; Kim et al., 2015). Auditors are assigned primarily to increase confidence that financial statements fairly represent the financial position of a firm. Earnings management may distort this "fair presentation" and be a real concern to auditors. Moreover, auditors will become more worried when management use questionable accounting practices (Jones, 2011). The broader accounting quality literature, according to Libby et al. (2015), has identified the importance of the external auditor's role in relation to earnings management practices as a potential monitor that may reduce such practices. However, auditors are often seen as trying to balance their wish to satisfy the client on one hand and to avoid litigation and regulatory consequences on the other hand, as well as being concerned about possible reputational damage. For Stolowy and Breton (2004), auditors are dealing with two important objectives; satisfying the client and avoiding risk from third parties.

This paper examines the perceptions of various stakeholders in relation to audit quality. Its primary objective is to capture the experiences of a range of stakeholders in relation to the audit quality of Libyan Commercial Banks (LCBs) by seeking their perceptions regarding the issue of earnings management. This paper investigates whether stakeholders' think auditors are able to detect and prevent earnings management practices

by LCBs and therefore provide a good quality audit. Research on audit quality in Libya has been relatively limited and calls have been made for more in-depth research on the topic (Zakari and Menacere, 2012; Sawan and Alsaqqa, 2013; Sawan and Alzeban, 2015). More generally, earnings management is perceived as a challenging issue by the financial reporting community due to its negative impact on financial reporting quality (Ascioglu et al., 2012; Habbash et al., 2013),

The paper proceeds as follows. Section 2 reviews the literature on earnings management and audit quality, including consideration of audit firm rotation and industry specialization as steps that may be taken to address concerns. The section also includes a brief overview of the accounting profession and banking audits in Libya. Section 3 provides the theoretical framework adopted by the paper, and Section 4 describes the research methodology. Section 5 discusses the paper's results; both from interviews and a questionnaire survey. Section 6 presents the summary and conclusion.

2. Literature review

The following section provides an overview of the literature that explains, first of all, what is meant by audit quality and how earnings management can affect it. The literature on two specific approaches to supporting audit quality is also considered, namely; auditor rotation and industry specialisation. The focus of this paper is to examine perceptions of the audit quality provided to LCBs and so literature pertaining to the regulatory framework of accounting in Libya will also be included in this section.

2.1 EM and Audit quality

Earnings management has been recognised as an attempt by managers to influence financial statements by using specific accounting methods to achieve some self-interested

goal (Akers et al. 2007). The external audit, according to Michas (2011), is likely to be important in emerging markets where there are no strong legal and financial institutions that reduce agency cost, as is arguably the case in Libya. It mitigates the problem of information asymmetry (Ojala et al., 2014). In particular, the external auditor plays a central role in the deterrence of earnings management behaviour (Cotter, 2012). The literature shows that a high quality external audit can have an influential role in reducing earnings management practices (Frankel et al., 2002). Audit quality has been defined in the literature in various ways and it should be noted that, according to Ojala et al., (2014), it is a complex concept that has no single agreed definition. It has been described as the *raison d'être* of the audit profession since the audit function would be of little or no value if it was of doubtful quality (Dickins et al., 2014). Much audit quality research, according to Kilgore et al., (2014), draws on DeAngelo's (1981) widely cited definition of audit quality that is the auditor's ability to discover and report a breach or misstatement in the accounting system or financial statements. Kilgore et al., (2014) report that the literature provides two approaches to test for audit quality; the first focuses on the audit process outcome e.g. errors made by the auditor resulting in an inappropriate audit opinion and/or deficient financial statements, while the second assesses audit quality from an ex-ante perspective. The second approach uses proxies to measure audit quality, e.g. firm size, litigation experience, auditor reputation, auditor tenure, non-audit services, audit structure, and industry specialisation. However, audit quality based on the second type can also be measured by examining the perceptions of individuals who are involved in, or affected by the audit (Kilgore et al., 2014). This paper examines audit quality by

addressing stakeholders' perceptions of the ability of the external auditors to detect and prevent the practices of earnings management by LCBs' managers.

2.2 Auditor firm rotation and audit quality

It is a “common assumption” that audit firm rotation increases audit quality (Ewelt-Knauer, 2012, p. 17). However, prior research on auditor independence reveals mixed results in regard to the relationship between firm rotation and audit quality. Johnson et al. (2002), for example, compared how short audit firm tenure (2-3 years) and medium audit firm tenure (4-8 years) would affect the quality of financial reporting. They found that short audit firm tenure is associated with lower financial reporting quality. Another study by Carcello and Nagy (2004) confirmed the research findings of Johnson et al. (2002). They found that fraudulent financial reporting is more likely to exist when there is short audit firm tenure. Cameran et al. (2008) tested how mandatory audit firm rotation would affect audit quality and found that there are no beneficial effects on audit quality as a result of mandatory audit firm rotation. Jackson et al. (2008) investigated the effect of mandatory audit firm rotation on audit quality in Australia and found that audit quality increases with audit firm tenure. They conclude that given the additional costs associated with switching auditors there are minimal, if any, benefits of mandatory audit firm rotation. They also suggested that regulators should consider other initiatives to address concerns about auditor independence and audit quality before imposing mandatory audit firm rotation. In Indonesia, it is compulsory to rotate the auditor every 3 years and to rotate the audit firm every 5 years. Siregar et al. (2012) tested the effect of this regulation on audit quality and found that both auditor and audit firm rotation did not increase audit

quality. They concluded that regulators may need to reconsider the regulation in order to increase audit quality.

On the other hand, there are some scholars who are in favour of mandatory audit firm rotation. Kramer et al. (2011) examined earnings quality using conservatism as a proxy (attribute). Their results indicate that conservatism in reported earnings decreases as the tenure of the audit firm lengthens. And as a result, they argued, audit firm rotation may have a positive impact on earnings quality. A recent study by Kim et al. (2015) investigated whether mandatory audit firm rotation enhances audit quality in Korea. Their findings suggest that mandatory audit firm rotation leads to better audit quality compared to voluntary audit firm rotation. In Libya, the Central Bank requires that a listed auditor can only audit a commercial bank for two consecutive financial years after which the auditor has to be rotated. In this limited context, and based on the literature reported above, the audit quality provided by listed auditors may be expected to be perceived as of good quality.

2.3 Industry specialization and audit quality

According to Krishnan (2003), specialist auditors are more likely to detect earnings management than non-specialists; they have the required experience and resources and are armed with an incentive (to maintain their reputation) to constrain earnings management. Ultimately reported earnings quality should therefore be enhanced. Industry specialists, according to Dunn and Mayhew (2004), possess the required industry specific knowledge and expertise and therefore can play a crucial role in monitoring the financial reporting process by providing high quality audit services to clients. Specialist auditors, according to Lowensohn et al. (2007), are more likely to detect errors in financial

statements than non-specialist auditors. Bruynseels et al., (2011) report that industry specialist auditors provide high audit quality and note that industry specialization is associated with, among other things, lower levels of earnings management. Dunn and Mayhew (2004) documented a positive association between industry specialist auditors and accounting quality in unregulated industries. However, they found no relationship in regulated industries.

The effect of auditor industry specialization on earnings management was also acknowledged recently by Sun and Liu (2013), who concluded that auditor industry specialization complements corporate governance effectively constraining earnings management.

The previously cited literature provides clear evidence of the ability of specialist auditors to better detect and prevent earning management practices, compared to non-specialists. In Libya, the Central Bank of Libya maintains a list of auditors who are approved to undertake bank audits. In order for an auditor to be listed, he/she has to demonstrate qualification and relevant experience, among other requirements. This institutional feature, i.e. the requirements by the Central Bank of Libya, provide a distinctive setting in which to explore perceptions of audit quality. It provides us with a setting where both mandatory audit firm rotation and auditor specialization are regulatory features. Such institutional features have been used previously in the literature when choosing a jurisdiction to test for audit quality, see, for example, Firth et al. (2012). The next two sub-sections outline respectively the regulatory frameworks of auditing and accounting in Libya; and, in particular, the regulations concerning banking are described.

2.4 Auditing in Libya

The accounting profession in Libya was governed for the first time by Law No. 116 that was enacted in 1973^{1,2} by which the Libyan Accountants and Auditors Association (LAAA) was established. The ability to supply audit services is restricted to LAAA members. Membership of the association requires that a candidate is a Libyan who has an accounting degree and who has experience of five years in an accountancy-related job after gaining their degree (Ahmed and Gao, 2004; Sawan and Alzeban, 2015). This law covers many issues relating to accounting practices in the country; the LAAA is the only responsible body to act with legal status in the area of auditing on behalf the State; moreover it “manages every facet of the auditing profession” (Ritchie and Khorwatt, 2007, p. 41). Ahmed and Gao (2004) summarised the objectives of the law as follows:

“(i) to organise and improve the conditions of the accounting profession and to raise the standards of accountants and auditors professionally, academically, culturally and politically; (ii) to organise and participate in conferences and seminars related to accounting internally and externally and to keep in touch with new events, scientific periodicals, lectures and so on; (iii) to establish a retirement pension fund for its members; (v) to increase co-operation between its members and to protect their rights; and (vi) to take action against members who violate the tradition and ethics of the profession” (p. 369).

However, Mahmud and Russell (2003) concluded that the LAAA had failed to achieve important objectives; for example, to establish or participate in research, conferences, and seminars or any activity that may have an influence over the profession’s development. It

¹ Before 1952 when Libya gained its independence, there was no national accounting body nor accounting firms, business firms at that time were served by foreign accounting firms from Italy and UK (Ahmed and Gao, 2004).

² During the 1950s and 1960s, most of the accounting firms which worked in Libya were either British or American; Libyan accounting firms have existed only since 1970 (Mahmud and Russell, 2003).

had, according to Mahmud and Russell (2003), failed even to regulate itself, let alone pursue its responsibility towards the public interest. Another critique of the LAAA by Mahmud and Russell (2003) was that the LAAA did not yet have a code of ethics.

In addition to the above critiques, Mahmud (1997) pointed out that the LAAA has failed to either organise or participate in any programmes that would develop the profession; in addition it was, at that time, unsuccessful in updating the profession about recent developments. He concluded based on the above, that the accounting profession in Libya was very weak³. El-Firjani (2010) concluded that the LAAA had had no real impact on the accounting profession in Libya, and, in particular, that it had failed to develop accounting practices. He added that accounting practices in Libya are mainly dependent on statutory regulations. However, it is worth noting that the LAAA attempted in 2006 to prepare national accounting standards by issuing the first Exposure Draft of a number of Libyan Accounting Standards (EDLASs). This draft consisted of 29 accounting standards mainly based on IFRS/IAS. However, due to weakness in the enforcement system, this draft is still not mandatory (El-Firjani, 2010). The accounting profession, according to El-Firjani (2010), is still immature as it is in the early stages of developing accounting practices. Moreover, a shortcoming of the LAAA, according to Sawan and Alezban (2015), is that it has not undertaken any classification of Libyan audit firms in terms of the number of staff, revenue, and resources. Such information could be of great interest in audit quality research in Libya.

Accounting practices in Libya have been influenced by a number of factors, one of which is the accounting education system (Mahmud and Russell, 2003); in this and other aspects

³ This situation still remains the case, and it may of course be even worse. As with other Libyan institutions, the LAAA is having to cope with the disruption caused by the Libyan revolution and its aftermath.

it has been influenced by Western accounting since “applied accounting principles and auditing standards in Libya follow those of the U.K. and the U.S” (Mahmud and Russell, 2003. p. 201)⁴. Another factor that may have had an influence over the accounting profession in Libya as identified by Ahmed and Gao (2004) is the discovery of oil. Since the late 1950s, when oil was discovered, the development of economic activities in Libya has resulted in more reliable accounting information becoming required for many users including management, investors, and government (El-Firjani, 2010).

2.5 The Libyan Commercial Banks Audit

The quality of the external audit is unobservable, however it can arguably be measured to some extent by, inter alia, auditor tenure (Piot and Janin, 2007). Libyan Commercial Banks are subject to supervision by the Central Bank of Libya (CBL) according to Banking Law no. 1 of 2005. The CBL, according to Article 71, is responsible for monitoring and controlling all commercial banks that operate within the country. Moreover, interrelationships between commercial banks are also monitored by the CBL. The law also contains articles that affect the accounting practices and financial reporting of the commercial banks. In Article 73, for example, a commercial bank must retain a capital reserve to which no less than 25% of net profit has to be transferred until it reaches 50% of the capital; afterwards 10% of the net profit is to be transferred each year to the reserve. Every commercial bank has to appoint two external auditors for its

⁴ The accounting education system was primarily based on UK and US systems; therefore, it is logical that the accounting profession is influenced by both UK and US practices. Practitioners are the products of the education system as emphasised by Ahmed and Gao (2004) who suggest that the educational system is the first stage in the qualifying accountants process.

financial year audit. These two auditors have to be registered⁵ with the Central Bank of Libya.

In the Libyan Commercial banks context, the length of an auditor-bank relationship is restricted to only two years, which may help to ensure that a high audit quality is being conducted (of course there is a counter argument that auditors' knowledge of the business is a positive function of tenure). If the previous auditor is to be reassigned, a cool-off period of at least one year has to pass. Firm rotation represents one of the most common mechanisms used to increase the auditor's independence which *ceteris paribus* may be expected to increase auditor willingness to challenge, and if necessary report on, earnings management (Libby et. al, 2015).

3. Theoretical framework and research questions

Much of earnings management research, according to Habbash and Alghamdi (2015), is based on statistical methods and only a few studies have addressed the issue using a qualitative approach; they argue that such an approach can help to provide a critical understanding of the issue. Regulators, for instance, would benefit from the findings of such studies; they will "put an accurate interpretation on such findings" (Habbash and Alghamdi, 2015, p. 123).

The findings of this paper are interpreted from an accountability perspective. The paper adopts a normative perspective whereby the findings are interpreted in terms of their relevance to the accountability mechanism. The objective role of accounting theory, according to Watts and Zimmerman (1978), is to "explain and predict accounting

⁵ Article 82 of the law requires the Central Bank of Libya to maintain a register of external auditors who are capable of auditing and inspecting banks' accounts.

practice”. However, the role of accounting theory can, and in the view of this author should, be more concerned about how accounting practice can be improved. Accountability is arguably something that everyone should respect. Bovens (2007) asserts that accountability is a “gold” concept that is widely supported and that is widely used in political discourse since it implies transparency and trustworthiness.

An accountability relationship implies that an accountant should provide an account to the accountee in order to discharge his/her accountability; the aim of such a relationship is to encourage the accountant to act in accordance with the accountee’s interests.

Perks (1993) provides a number of elements for an accountability system to perform effectively: production of financial information; the audit of accounting information; and the publishing of accounting information. The operating commercial banks in Libya are required by commercial law as well as banking law to prepare and publish their financial statements. According to Article (226) of the Libyan Commercial Law, boards of directors of companies have to prepare financial statements including notes. They are also required to submit a report highlighting the company's activity during the period. Moreover, listed banks have to prepare their accounts according to International Financial Reporting Standards (Kribat, 2009).

The second element of accountability (Perks, 1993) is the audit of accounting information. He believes that audited accounting information serves users better than unaudited information. The external audit function starts when the accounting process is completed; it represents the second stage in the process of holding accountable those responsible for the management of an organisation’s finances (White and Hollingsworth,

1999). The literature suggests that the external audit process has become an important factor within the accountability system based on the nature of the audit process⁶. Moreover, it is argued that auditing activities are the direct result of the need for accountability: “accountability is the *raison d’être* of auditing activities” (Gong, 2009, p. 5). He concluded that “audits are able to curtail the [misuse of power] by enhancing monitoring and supervision” (p. 6). Audit, according to White and Hollingsworth (1999), “provides professionally structured and independent information to a variety of actors in the accountability [process]” (p. 9). In this regard, Gong (2009), points out that a poor audit system “can leave the door open for irregular and illegal financial behaviors” (p. 6). In this context, Laffan (2003) suggests that financial accountability requires external auditing; she added that accountability is enhanced by the practice of audit in a professional manner as well as by reporting audit findings.

Article (18) of the Libyan Commercial Law requires every company to appoint a licensed auditor to audit its accounts while Article (209) states that an auditor has to issue an auditor's report embodying his opinion on a company's accounting affairs; this report has to assert the auditor’s opinion as to whether a company's accounts are faithfully presented and comply with the law. The auditor's opinion also has to refer to whether accounts have been prepared according to the approved accounting standards⁷. In terms of commercial banks, Banking Law No. 1 of 2005 requires that every bank’s accounts are certified by two external auditors. These auditors, according to Article 82 of the law, have to be

⁶ Some scholars, according to Gong (2009), argue that “auditing has strong anticorruption functions” due to the nature of audit work which puts the auditors in a position to uncover and deter potentially illegal or immoral behaviour.

⁷ The law has not defined what approved accounting standards are. Financial reporting in Libya is largely influenced by the legal system; in particular the Libyan mercantile law, income tax law, and banking law for commercial banks, are considered to be the most important legal factors that have shaped accounting practices in Libya (Shareia, 2014)..

included in a special register of those who are qualified and therefore authorized to audit banks.

The third element identified by Perks (1993) is the publication of accounting information. For accountability to be discharged, accounting information has to be communicated to stakeholders. According to Laffan (2003), accountability is promoted by the publication of the information. As discussed above, the commercial law requires a company to prepare and publish its financial statements; Article (227) indicates the items which must be included in the balance sheet of a company.

Although the above elements are basically required to ensure an effective accountability system, Perks (1993) acknowledges that in the real world accountability is often less than predicted. Therefore, a complete and effective accountability process cannot be assumed in Libya.

Based on the above discussion, the auditor's role within the accountability system should be clear; on one hand management has to provide financial information of good quality while the role of the external auditor is to provide assurance that the financial information is fair and true.

For the purposes of this paper audit quality is defined as the ability of the auditor to detect and report on earnings management practices. It is acknowledged that this definition is somewhat restrictive but we would argue that it is consistent with the definition by DeAngelo. It is also acknowledged that audit quality could be defined in a number of ways. It is, as mentioned earlier, a complex concept which could be differently perceived by different stakeholders. Different stakeholders have different views about

what audit quality refers to. Smith (2012) cited that stakeholders' perceptions on audit quality will depend on their involvement level with the audit process. In the same context, Knechel et al. (2013, p. 386) stressed that stakeholders' perceptions on audit quality are vary and largely dependent on "whose eyes one looks through" Users, for example, consider the absence of material misstatement as an indication for audit quality. Auditors, on the other hand, define audit quality as complying with all professional requirements. Similarly, regulators may perceive audit quality as being complying with both professional standards and legal requirements (Knechel et al., 2013). This paper seeks the perceptions of different stakeholders about audit quality, in particular, in relation to earnings management.

And therefore the key focus of this paper is to examine the stakeholders' perceptions as to whether the external auditor is able to provide good audit quality i.e. in being able to detect earnings management and potentially report on it. The paper also addresses stakeholders' perceptions of the accountability of auditors themselves within the overall accountability of the LCBs, and their perceptions of the use made of auditors' reports. Thus, the research questions can be formalized as follows:

RQ1. How do LCBs' stakeholders perceive the efficiency of the external auditor in relation to earnings management?

RQ2. How do LCBs' stakeholders perceive the accountability of the external auditor?

RQ3. How do LCBs' stakeholders perceive the use of the external auditor's report?

4. Research method

"... there has been a great deal of research into earnings management motivations using statistical methods⁸; however, few studies have offered a critical understanding of these problems through a survey such as interviews or

⁸ See for example, Corbella et al. (2015) employed two different measures of EM to test for audit quality

questionnaires and understanding the nature and problems of earning management practices is crucial in order for regulators to put an accurate interpretation on such findings” (Habbash and Alghamdi, 2015, p. 123).

This paper adopts a qualitative approach by examining the perceptions of LCBs' stakeholders regarding the role of the external auditor in relation to earnings management. It is hoped that this approach can help to address the identified lack of qualitative research on earnings management relative to that which has been quantitative in nature. The paper also seeks to provide insightful information for various stakeholders, in addition to the regulators mentioned by Habbash and Alghamdi (2015).

Consistent with Habbash and Alghamdi (2015) who use both questionnaire and semi-structured interviews to address earnings management practices in Saudi Arabia, this paper benefited from combining the two methods to explore the role of the external auditor in relation to the practice of earnings management by LCBs.

In the first stage, 28 semi-structured interviews were conducted through which stakeholders' views were sought about the external auditor's ability to detect and prevent earnings management practices. The interviewees were selected on the basis that they possessed the knowledge and the experience to contribute to the research. Interviewees have been divided into four groups, namely: Preparers (PR); Auditors (AD); Regulators (RG); and Users (US). Some interviewees hold more than one position; for example, PR5 is a bank chairman, external auditor and academic.

Table 1: Interviewee Groups

Group		Position	Qualification	Location
Preparers	PR1	Chairman	Msc	Commercial bank
	PR2	Head of Correspondent Banking Office	Msc	Commercial bank
	PR3	Member of BoD	PhD	Commercial bank
	PR4	Head of Accounting Dept.	BSc	Commercial bank
	PR5	Chairman	PhD	Commercial bank
	PR6	Head of Accounts Preparing Dept.	BSc	Commercial bank
	PR7	Head of Accounts Preparing Dept.	BSc	Commercial bank
	PR8	Head of Correspondent Banking	BSc	Commercial bank
	PR9	Vice Manager of Eastern Branches Management	Primary School	Commercial bank
	PR10	Head of Finance and Control	Msc	Commercial bank
	PR11	Head of Financial Management	BSc	Commercial bank
	PR12	Assistant Manager of Accounting Dept.	Diploma	Commercial bank
Auditors	AD1	Auditor	BSc	Audit firm
	AD2	Auditor	Msc	Audit firm
	AD3	Senior Partner	PhD	Audit firm
	AD4	Managing Partner	BSc	Audit firm
Regulators	RG1	Chief of Benghazi Branch	Msc	LAAA
	RG2	Inspector of commercial banks	BSc	CBL
	RG3	Inspector of commercial banks	Msc	CBL
	RG4	Banking Exchange Control Dept.	BSc	CBL
	RG5	Governor Deputy of CBL (Benghazi branch)	Msc	CBL
	RG6	Vice General Manager	BSc	Tax Authority
	RG7	Head of Listing and Follow-up Dept.	BSc	LSM
	RG8	Head of Internal Audit	BSc	LSM
	RG9	Manager of Surveillance & Follow-up Risks Dept.	Msc	LSM
	RG10	Legal Consultant	BSc	Commercial bank
Users	US1	Lecturer	PhD	Benghazi Uni.
	US2	Lecturer	PhD	Benghazi Uni.

Key: PR= Preparer, RG= Regulator, AD= Auditor, US= Users. BoD= Board of Directors, LAAA= the Libyan Accountants and Auditors Association, CBL= Central Bank of Libya, and LSM= Libyan Stock Market.

The second research method used was a questionnaire survey. This was undertaken in the period early January 2013 till February 2013 during which time 193 copies were given to various stakeholders of the Libyan Commercial Banks.

Table 2 summarizes the number of returned questionnaires categorized by different stakeholders.

Table 2: The Returned Questionnaires

Respondent Groups	Returned Questionnaires	Response Rate
Preparers	27	48%
Auditors	27	50%
Regulators	20	64%
Users	28	54%
Total	102	53%

The total proportions of each individual group (Preparers, Auditors, Regulators, and Users) are 26.5%, 26.5%, 19.6%, and 27.5% respectively; most are male (90 out of 102 or 88.2%). Twenty eight (27.5%) are professionally qualified, mainly being members of the Libyan Accountants and Auditors Association (LAAA) (24 or 23.5%). Ninety (88.2%) of the respondents have an academic qualification higher than a Diploma which suggests a good basic knowledge of financial issues. Most importantly, 78 (76.5%) of the respondents have indicated that they have banking experience which again gives a reasonable level of assurance as regards obtaining informed views about Libyan commercial banks (LCBs).

Once the responses were coded into an Excel spreadsheet, the data was transferred to the SPSS statistical package for analysis. This study focuses on different stakeholders' perceptions regarding the role of the external auditor in relation to earnings management practices in Libyan Commercial Banks; for this purpose, most questions were designed based on a five-point Likert scale.

Therefore, non-parametric tests were employed in this study, in particular the Kruskal-Wallis (KW) and Mann-Whitney (MW) tests. The KW test is used to identify whether any significant difference exists among the perceptions of the groups; if so, a MW test is carried out to determine which pairs of groups show significantly different perceptions.

For further illustration, descriptive statistics, means and standard deviations⁹, were also calculated to provide more insightful pictures of the perceptions.

As previously reported, the majority of the questions were based on 5-point Likert scales ranging from (1) strongly disagree (SD) to (5) strongly agree (SA). The findings discussion will be restricted only to those which have p-values of 0.05 or under.

5. Research findings

5.1 Interview Findings about the Role of the External Auditor

Initially interviewees were asked whether, and to what extent, they thought that the auditor is able to detect and prevent managers from being involved in earnings management. 25 (89%) of interviewees believe that the external auditor has the ability to detect the practice of earnings management, but only 7 (25%) think that the external audit does deter it.

All Preparers are in agreement about the external auditor's ability to detect earnings management but their views in respect of whether the external auditor can deter the practice of earnings management showed almost equal results; 5 of them believe that the external auditor can deter it while 6 Preparers hold the opposite view that they cannot deter it. All Auditors who have answered this question said that the external auditor can detect the practices of earnings management but will be unable to deter it. The majority of Regulators (9 out of 10) think that the external auditor can detect earnings management practices but only 2 (out 9 who believe he/she can detect) think that the external auditor can deter earnings management. The only User who answered this

⁹ Means and standard deviations are, strictly speaking, not appropriate as measures of ordinal data, but their use is widespread and they arguably have reasonable information content subject to assumptions made about the intervals in the ordinal data.

question gave the view that the external auditor is able to detect earnings management but is unable to deter it.

PR1, for instance, suggested that the auditor is able to prevent through his opinion and can detect the earnings management practices. On the other hand, the ability to prevent such a practice apparently is affected by a number of factors as will be discussed later. The majority of interviewees (89%) agreed that the external auditor can detect earnings management if he/she is qualified. As for preventing earnings management, responses come in different ways. Some say that he can prevent it through 'waving'¹⁰ his/her report and some say that he cannot prevent it for some reasons. PR4, for example, mentioned the fees amount that an auditor may lose in case of any conflict with management. He said:

"The auditor is supposed to be qualified to detect it through the process of audit. It depends on his personality if he is not caring about the money he would say "no". But actually most of them say ok. Our fees have reached 50,000 LD".

External auditor efficiency, which is a central issue within the accountability mechanism, is seen to be compromised by the high audit fees commercial banks usually pay and also the personality of the individual external auditor. Ironically, the external audit represents a very important element in the accountability process which theoretically should be enhanced by the payment of high fees to reflect rigorous and high quality audits. Those high fees themselves could, however, harm accountability due to the threat of financial dependence.

¹⁰ Threatening that he/she may issue a qualified opinion.

Also, interviewees perceived that an auditors' experience plays a significant role in detecting earnings management practices. In the first year of an audit, auditors may not be experienced enough in relation to understanding the new client's business to detect earnings management as expressed by PR5 and PR12 who respectively said:

"It depends on what is the experience of the auditor in terms of time; an auditor for one year could not, but an auditor who has being auditing for five years for instance could detect and can give some advice on how to reduce the practice".

"External auditor in his first time of auditing will not be able to detect it. But if he discovered he can prevent it".

The notion of audit tenure¹¹ was also mentioned in the response of PR10 who also blamed limited audit samples for not uncovering earnings management practices.

"To some extent, the external auditor can detect earnings management, but only to some extent as he will take samples. He will not be able to audit all transactions. When he detects the earnings management, it is supposed that he has the power to prevent it. Due to the limited number of auditors who are qualified to audit big institutions, the more the auditor becomes familiar with the institution the more the auditor creates a kind of relation with the institution that makes the auditor work for the management instead of shareholders".

The audit process itself could be seen, as in above quotation, as one of the factors that could affect the detection of earnings management practices. This was also stressed by US1, who considered the problem of audit samples by saying:

"Yes, the auditor can discover it. But not all earnings management practices because of audit samples. The auditor is one of the tools to discover earnings management practices. The auditor needs standards, and professional management in order to be able to discover, also has to be qualified. This is a big question that cannot be answered easily; auditor has to be protected when appointed and when terminated. He has to have standards to be applied".

¹¹ According to the CBL's regulation, an auditor can only be assigned for maximum two years for the same bank. However, the appointment may be renewed after a one year audit by another auditor.

Auditor independence represents a core element in the audit function and thus in the accountability process. AD1 described the relation between auditors and management by saying:

"Auditor assignment is 90% or 99% dependent on personal contacts so an auditor's decision is consistent with the management's desire".

In the same vein, RG1, when asked to rate the efficiency of listed auditors, mentioned the problem of personal contacts in appointing the external auditor. He said:

"Not all of them are at the same level of efficiency. Some audit assignments are based on personal contacts and are regardless of the effectiveness or efficiency".

The accountability process can be seen as less effective once an auditor's independence is compromised; therefore more efforts have to be taken in order to enhance auditor independence.

AD3 commented:

"If he was capable he would detect it. The profession is suffering. In Libya there is a problem unfortunately; industry got a lot of unqualified auditors meanwhile a lot of qualified people as well. The market and life circumstances play a role in making auditors give up (no resistance) to the management. I know and you know there are some auditors who only have one client and he is not braced for losing it".

The profession itself could contribute to an auditor's ability to detect and prevent earnings management practices. For example, PR3 has said:

"Most external auditors don't prevent the practice of earnings management. The audit function is traditional in Libya".

This suggests that the improvement of the entire profession (which arguably could start with the setting of accounting standards) is needed in order to back accounting practices and therefore facilitate the audit function. In other words, the conceptual framework would empower the accountability process.

PR10 also commented on this issue in assessing the listed auditors' efficiency by saying:

"They have the experience in banks audit. They have the ability. But they are a bit traditional, they are not following the technology".

Earnings management itself could be the reason why auditors cannot detect or prevent it.

RG8 commented:

"Well it is a new topic and most auditors have no idea about it so I think they cannot detect it. On the other hand, the independence of the auditor is all the time questionable".

The external auditor plays a crucial role in the accountability relationship; his/her role is to give assurance and confidence that financial statements faithfully represent the financial situation of the firm. This role may be impaired by some factors, as interview findings reveal a view that the external auditor's effectiveness may be affected by knowledge, experience, conflict of interest (fees, tenure) and audit procedures and sampling. Therefore, and based on interview findings, the external auditor's effectiveness is questionable and therefore accountability would be judged as being breached. Moreover, the interview findings reported earlier suggests that 89% of interviewees acknowledge the ability of the external auditor in detecting earnings management practices, but only 25% of interviewees believe that the external auditor is able to play a role in deterring LCBs managers from being engaged in earnings management. This suggests that accountability is to some extent affected by the personality of the external auditor that was suggested by PR4 when he was speaking about the high fees for bank audits.

Interviewees' views about the ability and efficiency of auditors who are listed at the CBL and thereby authorised to audit banks were also explored. Some interviewees accept that

most of those listed auditors have the capability to audit banks while others were more sceptical.

PR1 has stated:

"It is a very good question. Only those who have audited banks and got the experience. Not all of them are qualified to audit banks".

This might lead to the question of what standards does the CBL follow in listing external auditors. PR3 raised this query:

"The auditors who are listed and authorised to audit banks, I am not convinced about them, because there are no standards to accept the auditor and licence him to audit banks".

Interviewees were also asked to determine the extent to which the auditor's report is used by various stakeholders. Libyan stakeholders may lack the culture and tradition of reading the reports as declared by RG1 who said:

"Some ways of manipulation are easy to detect but giving a qualified opinion is not enough because of inaccuracy of the auditor's report on one hand. On the hand there is no report reading culture by interested parties... the use of the auditor report is very limited and in most cases is informal".

RG5 thinks that the auditor's report is only a legal requirement and that no one is using it.

He said:

"There is no relying on it at all. It is only a legal requirement".

RG9 also suggested:

"Unfortunately it is a legal requirement by the LSM and I don't think people are interested in it".

Interviewees view the CBL, LSM, tax authorities and management as the stakeholders who are most interested in the auditor's report. PR1 added correspondent banks as another party which is interested in the external auditor's report. He also commented on investors' use of the auditor's report. He said it was:

"Supposed to be very important for the CBL and the LSM and correspondents are very interested in the auditor's report. Investors are not, as they depend on their broker when deciding on buying or selling shares".

According to, PR4, no one is using the auditor's report. He noticed:

"Supposed to depend on it, but I don't think they do use it here".

The auditor's reputation may be an important factor in a report's use. PR11 stressed the good reputation of the auditor. He stated:

"The owners are much more interested in the detailed report¹² rather than an opinion report. Also the auditor himself plays an important role for example a report signed by one auditor, for example, will be accepted by the tax authority with no suspicion, on the other hand another auditor's report could be thrown away".

For AD4 only foreign companies are interested in the auditor's report while the local authorities only ask for it as a legal requirement. He observed:

"Frankly no one uses it [the auditor's report] except the foreign companies who send it to their head offices in order to make the consolidated statements. In Libya they use it as a legal requirement only. One time in a general assembly meeting the auditor was not invited to read his report".

As understood, the main functions of the external auditor are to examine the financial statements and to provide an opinion based on that examination. In other words, the external auditor's role within the accountability system is fulfilled when the external auditor's report is issued. In the case that this report is not being used, the accountability system may not be fully implemented. It could also reflect lack of awareness by various stakeholders about the accountability system in general and the role of the external auditor in the accountability process in particular.

¹² There are, in Libya, two reports an auditor has to submit to the general assembly; a detailed report which normally consists of auditor's remarks on the internal control system and any mistaken transactions, the other is the opinion report.

5.2 Questionnaire Results about the relationship between Earnings Management and the External Auditor

5.2.1 Perceptions about the Effectiveness of the External Auditor

As mentioned earlier, only specifically listed auditors are permitted to conduct an audit of banks. This requirement would imply that listed auditors are of high qualifications and experience, and thereby are effective and able to prevent or at least deter bank managers from being involved in earnings management practices. Stakeholders were asked to assess the capability of listed auditors for auditing banks and how able they are to deter and prevent earnings management. The use of the auditor's report in helping interested parties assess the bank's financial performance was also examined. In addition, a question addressed views as to whether the auditor's reporting is being used by the auditor to deter or prevent the practice of earnings management. The results are summarized in Table 3.

Table 3: Stakeholders' Perceptions about External Auditors Efficiency (K-W test)

Q	Statement	N	Mean	SD	Group Means				K-W P-value
					PR	AD	RG	US	
1	Listed auditors, in practice, are well qualified and capable to audit banks	102	3.18	1.066	3.30	3.11	3.20	3.11	.860
2	The auditor's report is relied upon when assessing a bank's financial performance	102	3.69	.844	3.85	3.37	3.65	3.86	.074
3	Listed auditors are likely to detect and deter earnings management practices in LCBs	102	3.37	.943	3.52	3.26	3.55	3.21	.523
4	An auditor's ability to report on earnings management is compromised by audit fees	102	2.98	.975	2.96	2.70	3.00	3.25	.253
5	An auditor's willingness to report earnings management breaches is compromised by conflict of interest to an auditor's independence	102	3.09	.902	2.96	3.07	3.00	3.29	.519
6	The external auditor can prevent the practice of earnings management using the power of the auditor's report	99	3.53	.849	3.81	3.12	3.58	3.61	.025*

Note: This table shows the mean and standard deviation (SD) for all respondents regarding questions about the external auditor's efficiency. It also provides the mean for each group and the p-value for the Kruskal-Wallis (K-W) test. Groups are defined as; preparers (PR), auditors (AD), regulators (RG), and users (US) for each question. Bold figure indicates significance at the 5% level.

A 5-point Likert scale was used in these questions. It ranged from 1= “Strongly disagree” to 5= “Strongly agree”.

As shown in Table 3, the mean scores indicate that stakeholders groups agreed to most of the questions. Listed auditors, according to stakeholders groups, were viewed as qualified and capable of performing banks’ audits with an average mean of 3.18. It is worth noting that some of the interview findings suggested that at least not all of the listed auditors are perceived as well qualified and able to audit banks due to experience discrepancies among listed auditors as per, for example, PR5:

“It depends on what is the experience of the auditor in terms of time; an auditor for one year could not, but an auditor who has being auditing for five year for instance could detect and can give some advice on how to reduce the practice”.

The stakeholder groups agreed, on balance, also that the auditor’s report is being used to help assess the financial performance of banks which again is unexpected and is in conflict with some of the interview findings that suggest auditors’ reports are only a legal requirement and nearly ignored in the decision making process.

In keeping with the first finding in this table, stakeholders agreed on balance that listed auditors are able to detect and deter earnings management practices by LCBs which may indicate that this ability is not compromised by any factor i.e. audit fees. However, stakeholder groups disagreed, on balance, that audit fees affect the auditor’s ability to report on earnings management, the overall mean score is 2.92. This result is in contrast to some views expressed in the interviews; for example, one of the interview findings offered by PR4 suggests that bank audit fees may affect the external auditor’s ability to report about earnings management practices by LCBs.

The relative disagreement regarding audit fees' impact on an auditor's ability to report on earnings management could be partially due to the fact that the Auditors group tends, more than others, to disagree with this statement by giving the least mean score of 2.70. Given the questionnaire responses reported by Auditors only, it is clear the general attitude of Auditors tends to the disagreement side. The Auditors have shown 4 strongly disagree individual responses, the most compared to other groups, and 7 disagreements. However, due to the sensitivity of such a question, this may be influenced by their desire to appear not compromised by audit fees. Preparers' responses are spread equally; 10, on the side of disagreement, including 2 strongly disagrees, and 10 on the side of agreement, including 1 strongly agree.

Stakeholder groups have shown, on balance, a perception that an auditor's willingness to report about earnings management is affected by conflict of interest and thereby auditor's independence is compromised. In other words, there are some perceptions that reporting about earnings management breaches may lead to termination of an appointment which would affect the auditor decision, and thus his/her independence is compromised. The last question asked about the external auditor's ability to prevent earnings management practices just by the power of the audit report. In other words, if bank managers did not adjust the reported income to undo the earnings management practices according to the external auditor's notes, a qualified opinion will be given by the auditor. Stakeholder groups agreed, on balance, the effective power of the auditor's report. Needless to say no single client would be happy to receive a qualified report.

The perceptions of questionnaire respondents are broadly in line those of the interviews as reported in Section 5.1 regarding the ability of the external auditor in detecting the

earnings management. On balance, there is agreement by questionnaire respondents' regarding the ability of the external auditor to both detect and deter earnings management practices. The mean score for this question was 3.37 (Q 3). In a more specific question regarding the ability of the external auditor to prevent earnings management practices (Q 6), respondents, on average, apparently agree that the external auditor is able to deter such behaviour, moreover this can be achieved through the power of the external auditor's report. However, the interview findings reported earlier refer to a contradictory view which is that the external auditor is able to detect the practice of earnings management, but, as for deterring this practice, only 25% of interviewees think that the external auditor is able to do that.

It has previously been found, see, for example, Smith (2012) and Knechel et al. (2013), that different stakeholders can have different views on audit quality. Consistent with such findings, the results reported in Table 3, while showing wide agreement between stakeholder groups, show that Users are more doubtful of the ability of auditors to report on EM due to audit fees as well as a perceived conflict of interest. It is also worth noting that the Auditors group showed less confidence, for example when compared to the Users group, about audit quality. Notwithstanding the reservations apparently held by users regarding audit fees and conflicts of interest, the results show that, in general, regulators and preparers, as well as users in some cases, have more confidence in the effectiveness of the audit function than do auditors themselves. It could be that the mandated requirements of the Central Bank of Libya for listed auditors could have a bearing on stakeholders' perceptions. This may contribute to a view that listed auditors are well qualified and positioned in a way that enables them to provide high audit quality. On the

other hand, the more modest views of auditors themselves about their effectiveness could potentially refer to the challenges and difficulties experienced by auditors of which other stakeholders are less aware.

The results articulated in Table 3 reveal only one significant difference; therefore, a Mann-Whitney test was implemented to identify which pairs have conflicting views. The results of these tests are presented in Table 4.

Table 4: Stakeholders' Perceptions about External Auditors Efficiency: M-W test

Q	Statement	K-W P-values	M-W p-values					
			PR-AD	PR-RG	PR-US	AD-RG	AD-US	RG-US
1	Listed auditors, in practice, are well qualified and capable to audit banks	.860	.481	.714	.533	.564	.905	.798
2	The auditor's report is relied upon when assessing a bank's financial performance	.074	.032*	.262	.972	.265	.037*	.290
3	Listed auditors are likely to detect and deter earnings management practices in LCBs	.523	.305	.987	.268	.374	.816	.280
4	An auditor's ability to detect earnings management is compromised by audit fees	.253	.386	1.000	.335	.278	.057	.249
5	An auditor's willingness to report earnings management breaches is compromised by conflict of interest to an auditor's independence	.519	.554	.836	.213	.553	.488	.209
6	The external auditor can prevent the practice of earnings management using the power of the auditor's report	.025*	.005*	.246	.420	.054	.042*	.783

Note: This table shows the p-values produced by M-W test between the different groups regarding questions about the external auditor's efficiency. Groups are defined as; preparers (PR), auditors (AD), regulators (RG), and users (US) for each question. Bold figure indicates significance at the 5% level. A 5-point Likert scale was used in these questions. It ranged from 1= "Strongly disagree" to 5= "Strongly agree".

Although one significant difference resulted from the KW test, four significant differences appeared when the MW tests were performed. The first resulted between the Preparers and Auditors groups regarding the use of the external auditor's report, it can be seen from Table 4 that both groups agreed to reliance being placed on the auditor's report

in the financial decision making process. Also, Preparers and Users groups seemingly have a conflict of views in this respect as the MW test results in a significant difference between them (.037). The Preparers and Auditors again show a significant difference in connection with the influence of the external auditor's report in preventing earnings management practices, and there was also a significant difference between Preparers and Users regarding the same question. However, all groups' means reveal an aggregate level of agreement with the last question.

The implications of the results reported above in Tables 3 and 4 on the accountability process stem basically from the importance of the role of the external auditor within the accountability process. This role relies mainly on the qualification and independence of the external auditor. If these qualities are in question then so will be the external audit efficiency resulting in impaired accountability of LCBs. The next section discusses, in addition to the use of the external auditor's report, whether the external auditor is aware of his/her accountability towards stakeholders other than shareholders.

5.2.2 Perceptions about External Auditor Accountability

This section examined perceptions of different stakeholders concerning the external auditor's awareness of his/her own accountability. Respondents were asked to indicate their agreement or disagreement as to whether external auditors are aware of their responsibility towards shareholders and other parties who may make a decision based on the external auditor's report. The section also surveyed perceptions of the use of the external auditor's report by stakeholders. Finally, the section also examined one of the points made by an interviewee that the external auditor's report is only a legal

requirement and that it is not used in the financial decision making process. The results are presented in Table 5.

Table 5: The External Auditor's Accountability and the Extent to Which His/Her Report is used: K-W test

Q	Statement	N	Mean	SD	Group Means				K-W P-value
					PR	AD	RG	US	
1	External auditors are fully aware of their accountability to the shareholders	98	3.46	1.047	3.64	3.64	3.80	3.07	.074
2	External auditors are fully aware of their accountability to the third parties	97	3.33	.898	3.56	3.56	3.47	3.04	.128
3	The auditor's report is widely used by interested stakeholders	98	3.46	.864	3.80	3.80	3.65	3.14	.040*
4	The auditor's report is only a legal requirement and not used widely in the financial decision making process	98	2.85	1.068	2.52	2.52	2.70	3.00	.223

Note: This table shows the mean and standard deviation (SD) for all respondents regarding questions about the auditor's accountability and his report extent. It also provides the mean for each group and the p-value for the Kruskal-Wallis (K-W) test. Groups are defined as; preparers (PR), auditors (AD), regulators (RG), and users (US) for each question. Bold figure indicates significance at the 5% level. A 5-point Likert scale was used in these questions. It ranged from 1= "Strongly disagree" to 5= "Strongly agree".

Table 5 shows the overall mean responses for these questions. The average responses indicate that, overall, stakeholders groups agree that the external auditor is mindful of his/her responsibility and accountability not only to shareholders but beyond; the results also reveal that external auditors are aware of their accountability to third parties. The average means were 3.46 and 3.33 respectively. Stakeholder groups also agreed that the auditor's report is widely used by interested stakeholders in the decision making process with a mean score of 3.46, and, unexpectedly, refuted the notion that the auditor's report is only a legal requirement and not widely used in financial decision making. This result is at variance with the interview findings reported earlier as some interviewees indicated that the external auditor's report is not widely used. RG5, for example, stated that "There is no relying on it [the auditor's report] at all. It is only a legal requirement".

The K-W test points out a significant difference amongst the groups regarding the use of the external auditor's report by interested stakeholders. To identify which pairs have significantly differing viewpoints, M-W test was performed and the results are shown in Table 6.

Table 6: The External Auditor's Accountability and the Extent to Which His/Her Report is used: M-W test

Q	Statement	K-W P-values	M-W p-values					
			PR-AD	PR-RG	PR-US	AD-RG	AD-US	RG-US
1	External auditors are fully aware of their accountability to the shareholders	.074	.496	.549	.040*	.243	.215	.024*
2	External auditors are fully aware of their accountability to the third parties	.128	.290	.562	.027*	.665	.228	.113
3	The auditor's report is widely used by interested stakeholders	.040*	.043*	.627	.012*	.209	.507	.085
4	The auditor's report is only a legal requirement and not used widely in the financial decision making process	.223	.052	.550	.172	.191	.734	.437

Note: This table shows the p-values produced by M-W test between the different groups regarding questions about the auditor's accountability and his report extent. Groups are defined as; preparers (PR), auditors (AD), regulators (RG), and users (US) for each question. Bold figure indicates significance at the 5% level.

A 5-point Likert scale was used in these questions. It ranged from 1= "Strongly disagree" to 5= "Strongly agree".

The results shown in Table 6 show a number of significant differences. Preparers and Users groups have shown different views regarding the auditors' awareness of their accountability towards shareholders; although both agreed with the statement on balance as their mean scores in Table 5 indicate (although the Users group's agreement is only slightly above the mid-point being 3.07). Regulators and Users have also shown a disagreement regarding this question. The second statement has a significant difference between Preparers and Users, who have generated mean scores of 3.56 and 3.04 respectively, it is notable that the Preparers' mean is the highest while the Users is the lowest.

Although Preparer and Auditor groups generated the same mean score of 3.80 regarding the use of the auditor's report by stakeholders, M-W results reveal a significant difference between these two groups towards this statement. The M-W results also show a significant difference for this statement between preparers and users groups whose mean scores are 3.80 and 3.41 respectively.

5.2.3 Perceptions about the Use of the External Auditor's Report by Various Stakeholders

The use of the auditor's report has been discussed earlier; this section reports, in particular, which stakeholders are perceived to be using the external auditor's report. Respondents were asked to assess the use of the external auditor's report by a certain list of stakeholders. The listed stakeholders have been partially mentioned in the interviews, others are drawn from the literature. However, the results shown in Tables 7 and 8 reveal no significant differences and the respondent groups all agreed (on aggregate) and with different levels, that the auditor's report is being used by these stakeholders.

Table 7: The External Auditor's Report Use by Various Stakeholders: K-W Test

Q	Statement	N	Mean	SD	Group Means				K-W P-value
					PR	AD	RG	US	
1	Shareholders	99	3.88	.848	4.04	3.72	3.90	3.86	.487
2	Management	99	3.70	.963	3.85	3.40	3.95	3.64	.304
3	Employees	98	3.22	.914	3.36	3.08	3.45	3.07	.475
4	Tax authority	98	3.76	.909	3.96	3.58	3.80	3.68	.531
5	Current and potential customers	96	3.49	.962	3.58	3.52	3.47	3.39	.864
6	The Libyan Stock Market	98	4.02	.786	3.92	3.88	4.10	4.18	.309
7	Central Bank of Libya	99	4.09	.771	4.15	3.96	4.00	4.21	.376
8	Corresponding banks	96	3.64	.964	3.58	3.60	3.75	3.63	.989
9	Media	97	3.27	1.005	3.25	3.28	3.45	3.14	.825
10	Academia and research centres	98	3.43	.952	3.48	3.44	3.70	3.18	.359
11	Society as a whole	97	3.24	.966	3.42	3.24	3.40	2.96	.411

Note: This table shows the mean and standard deviation (SD) for all respondents regarding questions about who use the auditor's report. It also provides the mean for each group and the p-value for the Kruskal-Wallis (K-W) test. Groups are defined as; preparers (PR), auditors (AD), regulators (RG), and users (US) for each question. Bold figure indicates significance at the 5% level.

A 5-point Likert scale was used in these questions. It ranged from 1= "Strongly disagree" to 5= "Strongly agree".

As the results in Table 7 suggest, no significant differences appeared from the K-W test. This is also supported by the mean scores all being above 3 which indicates, unexpectedly, a view that all listed stakeholders, on balance, and on aggregate, are using the external auditor's report. However, The Central Bank of Libya and the Libyan Stock Market are the users for whom there is strongest agreement that they use the external auditor's report with mean scores of 4.09 and 4.02 respectively. On the other hand, Employees have been indicated as users of the external auditor's report with the lowest mean score of 3.22.

Table 8: The External Auditor's Report Use by Various Stakeholders: M-W test

Q	Statement	K-W P-values	M-W p-values					
			PR-AD	PR-RG	PR-US	AD-RG	AD-US	RG-US
1	Shareholders	.487	.148	.546	.460	.430	.416	1.000
2	Management	.304	.118	.704	.675	.076	.345	.445
3	Employees	.475	.336	.860	.305	.250	.895	.217
4	Tax authority	.531	.103	.438	.551	.479	.563	.893
5	Current and potential customers	.864	.537	.405	.566	.721	.841	1.000
6	The Libyan Stock Market	.309	.630	.685	.225	.356	.101	.398
7	Central Bank of Libya	.376	.328	.570	.413	.815	.137	.259
8	Corresponding banks	.989	.709	.949	.996	.789	.875	.773
9	Media	.825	.936	.604	.681	.560	.644	.395
10	Academia and research centres	.359	.809	.374	.302	.287	.390	.119
11	Society as a whole	.411	.484	.999	.155	.568	.359	.205

Note: This table shows the p-values produced by M-W test between the different groups regarding questions about who use the auditor's report. Groups are defined as; preparers (PR), auditors (AD), regulators (RG), and users (US) for each question. Bold figure indicates significance at the 5% level.

A 5-point Likert scale was used in these questions. It ranged from 1= "Strongly disagree" to 5= "Strongly agree".

The results in Table 8 point out no significant differences between any two groups in respect of the using of the auditor's report by the various stakeholders. These results indicate, on balance, wide use of the external auditor's report by shareholders and other stakeholders.

6. Summary and Conclusion

The external auditor represents a key element in the accountability mechanism. Their important role, providing assurance and improving the credibility of the financial statements, increases public confidence in respect of the reliability and relevance of the provided financial information i.e. by providing an audit of good quality. It arguably can be said that a good quality audit would reduce or prevent earnings management practices thus helping to provide financial information which would be of good quality and ultimately one can argue good audit quality has a crucial role in promoting the accountability system. As mentioned earlier, only registered auditors with the CBL are authorised to perform the audit of banks which implies a certain level of audit quality is required by the CBL. Based on this one could have a reasonable expectation that good quality audits are being carried out in LCBs and therefore LCBs' financial reporting is of a reasonable level of quality i.e. unbiased accounting information is being provided.

Interviewees were asked to assess the role of the external auditor in respect of earnings management by LCBs' managers. Although they expressed the view that registered auditors are able to detect earnings management practices of LCBs, they were doubtful, for various reasons about the ability of the external auditor when it comes to preventing or deterring the practices. 89% of interviewees had the view that the auditor is able to detect earnings management but 75% of them thought that the auditor is unable to prevent such a practice. Some other issues were referred to as reducing the external auditor's ability to detect or prevent earnings management, these were: lack of knowledge, limited experience, conflict of interest, and audit sampling. The accountability then can be perceived as being compromised given the perceived inability

of the external auditor to both detect and prevent earnings management and as a consequence the audit function is being provided at a low level of quality.

Based on such a finding one can argue that LCBs' stakeholders have reduced trust¹³ in the auditing profession. It could also be inferred that LCBs' are basing their decisions on other sources rather than audited financial statements. This would be in line with Malsch and Gendron (2009) who found that investment decisions are being taken based on the quality of management rather than the content of financial statements. Financial analysts may be thought to behave as though they rely on auditors and depend on audit quality as being crucial to their daily business. However this collective imagery may not reflect the reality. According to Malsch and Gendron (2009), the assessment of management integrity and competencies is a more important basis on which investment decisions are made.

The role of the external auditor was examined in more detail by the questionnaire survey. The external audit function is related to the accounting standards as it is part of the auditor's job to ensure financial statements have been prepared in accordance with the adopted framework i.e. accounting standards. Previous literature reports that the lack of accounting standards in Libya would make such a mission a challenging task in many aspects: lack of a framework leads to financial information being unstable, the accounting practices applied in one year may not be applied in the next period or it may happen that two banks apply different practices. In addition, the verifiability characteristic would not be an easy task, absence of accounting standards could lead to different outcomes if

¹³ Trust can broadly be defined as "a mechanism that can reduce uncertainty in context of interaction and facilitate the functioning of organizational systems" (Malsch and Gendron, 2009, p. 739).

financial information were to be produced by another accountant. The lack of accounting standards may also open the door for managers to apply any accounting practice that serves their own benefit and present the financial statements in a favourable position to their stakeholders. To sum up, it could be argued that deficient, or lack of, standards leads to a deficient audit function.

The questionnaire results showed, on balance, agreement by LCBs' stakeholders that the ineffective function of the external audit, as well as the difficulty of detecting earnings management by auditors may be reasons why earnings management is taking place in LCBs' financial reporting.

Another result revealed stakeholders' agreement that educating the external auditor may have a positive impact on the external auditor's ability to deter earnings management behaviour. This result led to the inference that listed auditors are not trained and educated well enough to detect the behaviour. Moreover, the questionnaire results reveal that listed auditors are relatively (on balance) in a good position that enables them to detect and deter earnings management practices of LCBs' managers. This finding is consistent with a number of findings in the literature which give support to audit specialization. e.g Krishnan (2003), Dunn and Mayhew (2004), Lowensohn et al. (2007), and Bruynseels et al., (2011) who concluded that specialized auditors are more likely to detect errors in financial statements than non-specialist auditors. Similarly, our findings are consistent with, for example, Kramer et al. (2011) and Kim et al. (2015) regarding the positive effect of audit firm rotation on audit quality. Also, the paper has provided evidence that audit quality may be perceived differently by different stakeholders as found by, for example, Smith (2012) and Knechel et al. (2013). The sanction through which auditors are

able to deter earnings management practices, according to the questionnaire results, is the auditor's report. In this context another difference arose between the interview findings and the questionnaire results. Interviewees had the view that listed auditors are unable to deter earnings management practices referring to some issues to support this notion, e.g. audit fees and the lack of significance of the external auditor report since in some cases it is only regarded as a nominal legal requirement. On the other hand, questionnaire respondents agreed that the auditor's report does deter the practice implying a more effective accountability process, through higher audit quality.

Other issues were explored in the questionnaire regarding perceptions of the external auditor. LCBs' stakeholders showed, on balance, agreement that the external auditor is aware of his/her accountability to shareholders and other parties and also that the auditor's report is not only a legal requirement but is being widely used by various stakeholders contrary to most of the views expressed in the interviews. Specifically, the questionnaire results showed, on average, agreement that the auditor's report is being used by: shareholders, management, employees, the tax authority, customers, the Libyan Stock Market, the CBL, corresponding banks, the media, academia, and society as a whole.

Although the questionnaire results in many aspects show support for the current status of the bank audit function, in contrast to the interview findings, LCBs' stakeholders did perceive a weakness in the regulatory regime. They agreed, on balance, to the need to strengthen both audit regulation and oversight of financial reporting. This could be seen to imply that the accountability of LCBs does require additional tools in order to be enhanced. The institutional context of bank audits in Libya is regulated by more than

statutory legislation, it includes, for example, the CBL's requirements for bank auditors' qualifications and experience. However, this may not be sufficient to provide good audit quality and therefore more measures may be required. This suggests that, to enhance the accountability process of LCBs, efforts should be made to enhance the audit function by strengthening it through legislation. Also, oversight of the financial reporting function, which does not exist at the moment, should be established so that the accountability system can be further enhanced. Literature findings on the weaknesses of the accounting profession in Libya can point to potential reasons for such an audit quality level. Further research can help to identify how the accounting profession in Libya can be improved. And as a result the accountability process could be strengthened not only within the banking industry, but in the wider economy. Gray et al. (2015) have highlighted the close relationship between audit and accountability and it seems clear that without a trusted audit function there will be a serious lack of accountability in terms of perception and of substance.

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Appendix

Questionnaire Survey

Part 1 :General Information (Please respond by ticking (v) in the appropriate box)

Please indicate your age

Less than 25 years old	Between 26 and 30 years old	Between 31 and 40 years old	Between 41 and 50 years old	Over 50 years old

1.1 Please indicate your gender: M (), F ()

2. Are you professionally qualified in accountancy or finance? Yes () No ()

If yes, please indicate which of the following professional qualifications that you have:

Professional Body	
LAAA	
ICAEW	
CIMA	
ACCA	
AICPA	
Other, please specify	

3. What is your highest educational qualification?

Qualification	
Diploma	
Bachelor degree	
Master degree	
Doctorate	
Other, please specify	

4. Please indicate your place of education for your highest degree

Place	
Libya	
Other Arab country	
UK	
USA	
Other, please specify	

5. Please tick your place of work and position

Place of Work		position
A commercial bank		
Central Bank of Libya		

The Libyan Stock Market		
Tax Authority		
Audit Firm		
State Audit		
Current or potential investor		
Academia and Research Centres		
Other, please specify		

6. Please indicate the work experience, if any, that you have:

Less than 5 years		Between 5 and 10 years	
Between 11 and 15 years		Over 15 years	

7. Where applicable, please describe any work experience that you have had in the Libyan banking sector (e.g. accountant for 5 years, internal auditor for 3 years)

Part 2

EM and Audit Quality

According to Libyan regulations, only auditors who are listed with the Central Bank of Libya are allowed to audit Libyan commercial banks. This restriction implies that those “listed auditors” are qualified to undertake an effective audit for banks. To what extent do you agree or disagree with the following statements:

(Note: SD = strongly disagree, D= disagree, NAD= neither agree nor disagree, A= agree and, SA= strongly agree)

Statement	SD	D	NAD	A	SA
Listed auditors, in practice, are well qualified and capable to audit banks					
The auditor's report is relied upon when assessing a bank's financial performance					
Listed auditors are likely to detect and deter earnings management practices in Libyan commercial banks					
An auditor's ability to report on earnings management is compromised by audit fees					
An auditor's willingness to report earnings management breaches is compromised by conflict of interest to an auditor's independence					

The external auditor can prevent the practice of EM using the power of the auditor's report					
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3.2 Please indicate the extent by which you agree or disagree with the following statements:
(Note: SD = strongly disagree, D= disagree, NAD= neither agree nor disagree, A= agree and, SA= strongly agree)

Statement	SD	D	NAD	A	SA
External auditors are fully aware of their accountability to the shareholders					
External auditors are fully aware of their accountability to the third parties					
The auditor's report is widely used by interested stakeholders					
The auditor's report is only a legal requirement and not used widely in the financial decision making process.					

Presumably, an auditor's report is used by several parties when making economic decisions regarding financial statements. Please indicate to what extent you agree or disagree that the following stakeholders place greater trust in financial statements of Libyan commercial banks as a result of the auditor's report than they would otherwise do:

(Note: SD = strongly disagree, D= disagree, NAD= neither agree nor disagree, A= agree and, SA= strongly agree)

Users	SD	D	NAD	A	SA
shareholders					
Management					
Employees					
Tax department					
Current and potential customers					
The Libyan Stock Market					
Central Bank of Libya					
Corresponding banks					
Media					
Academia and research centres					
Society as a whole					
Other, please specify					

The researcher would like to take the opportunity to thank you for filling in the questionnaire. Also, if you would like to receive a summary of the research results and findings please write down your name and contact details. Thank you.

Name	
Address	
Email	
Phone number	
Fax number	